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EXPOSURE DRAFT

**PROPOSED STATEMENT ON
AUDITING STANDARDS**

**SPECIAL-PURPOSE REPORTS FOR USE BY OTHER
AUDITORS**

OCTOBER 15, 1981

Prepared by the AICPA Auditing Standards Board
For comment from persons interested in auditing and reporting

Comments should be received by February 15, 1982, and addressed to
AICPA Auditing Standards Division, File 4327
AICPA, 1211 Avenue of the Americas, New York, N.Y. 10036

SUMMARY

This proposed Statement on Auditing Standards provides guidance on how, under certain circumstances, one independent auditor might use a special-purpose report of another independent auditor because of its relevance to his own examination and provides guidance on the preparation of such reports. Such reports might be useful in examining the financial statements of a client that uses accounting or custodial services provided by the following types of organizations.

- Service centers that provide data processing functions for other organizations.
- Reinsurers that maintain accounting for ceded policies.
- Securities depositories or clearing organizations that perform services such as the execution and clearance of trades for another broker or dealer.
- Bank trust departments, or similar entities, that provide services such as administering pension plans.
- Mortgage bankers or savings and loan associations that service loans for others.
- Banks or trust companies acting as registrar or transfer agent for a corporation.

The proposed SAS would require an independent auditor to determine whether significant transactions are processed or significant assets or liabilities are handled by an organization that provides accounting or custodial services to a client and to consider the division of control functions between the client organization and the service organization. The independent auditor might need to obtain a report on aspects of the service organization's system of internal accounting control if he intends to rely on controls maintained by the service organization in conducting his examination.

The Auditing Standards Board has considered several alternatives for dealing with situations in which a client uses accounting or custodial services of a service organization. Those alternatives included the following levels of auditing at the service organization (by either the service auditor or the user auditor) on those aspects of the service organization relevant to the audit of the user organization:

1. Substantive audit tests.
2. Internal control evaluation procedures.
3. No audit procedures if financial statements of the service organization demonstrating fiscal responsibility are available to the user auditor.

The Board believes that alternative one, although the most effective, would be impracticable or excessively costly and result in duplication of effort and disruption to the service organization. Alternative three would be the least costly, but would not provide adequate assurance to those relying on audited financial statements of the user organization. Alternative two offers a reasonable degree of assurance at moderate cost and is, therefore, the alternative incorporated in this exposure draft.

This exposure draft has been sent to

- *practice offices of CPA firms*
 - *members of AICPA Council and technical committees*
 - *state society and chapter presidents, directors, and committee chairmen*
 - *organizations concerned with regulatory, supervisory, or other public disclosure of financial activities*
 - *persons who have requested copies*
-



American Institute of Certified Public Accountants

1211 Avenue of the Americas, New York, New York 10036 (212) 575-6200

October 15, 1981

Accompanying this letter is an exposure draft of a proposed Statement on Auditing Standards entitled Special-Purpose Reports for Use by Other Auditors. A summary of the proposed SAS also accompanies this letter.

Comments or suggestions on any aspect of this exposure draft will be appreciated. The AICPA Auditing Standards Board's consideration of responses will be helped if the comments refer to the specific paragraph numbers and include supporting reasons for any suggestions or comments.

In developing guidance, the AICPA Auditing Standards Board considers the relationship between the cost imposed and the benefits reasonably expected to be derived from audits. It also considers differences that the auditor may encounter in the audit of the financial statements of small businesses and, when appropriate, makes special provisions to meet those needs. Thus, the board would particularly appreciate comments on those matters.

Written comments on the exposure draft will become part of the public record of the AICPA Auditing Standards Division and will be available for public inspection at the offices of the American Institute of Certified Public Accountants after March 15, 1982, for one year.

Responses should be sent to the AICPA Auditing Standards Division, File 4327, in time to be received by February 15, 1982. For convenience in responding, a postpaid mailer is attached to this exposure draft.

Sincerely,

A handwritten signature in cursive script that reads "James J. Leisenring".

James J. Leisenring, Chairman
Auditing Standards Board

A handwritten signature in cursive script that reads "D.R. Carmichael".

D.R. Carmichael, Vice President
Auditing

PROPOSED STATEMENT ON AUDITING STANDARDS

SPECIAL-PURPOSE REPORTS FOR USE BY OTHER AUDITORS

1. This Statement provides guidance on how, under certain circumstances, one independent auditor might use a special-purpose report of another independent auditor because of its relevance to his own examination. For example, the system of internal accounting control of one entity (or organization unit) may be relevant to the scope of the auditor's examination of the financial statements of another entity that uses the services of the other entity to process financial records or to hold or transfer assets or liabilities. This Statement also provides guidance on the preparation of such reports.¹

2. For purposes of this Statement, (a) the entity whose financial statements are being examined is referred to as the "client organization," (b) the auditor of that entity is referred to as the "user auditor," (c) the entity who provides services to the client organization is referred to as the "service organization," and (d) the auditor who reports on the internal accounting control or related matters of the service organization is referred to as the "service auditor." Various types of service organizations are listed in the Appendix of this Statement.

3. When a client uses accounting or custodial services of a service organization, much of the processing of transactions and handling of related assets may flow through accounting applications that are an extension of, but physically and operationally external to, the client organization. It is generally not practicable or economical for the independent auditor of each client organization to make a study and evaluation of the system of

internal accounting control maintained by a service organization to determine the reliance that may be placed thereon in restricting the extent of substantive tests. Also, service organizations often use standardized procedures for a large number of users with little or no variation in procedures for each. Thus, a service organization often engages one independent auditor to report on its system of internal accounting control and related matters to the independent auditors of the client organizations that use its services. The type of engagement to be performed and the report to be prepared may be established by the service organization, but discussions by the service auditor with user auditors are advisable to determine the type of report that will be suitable for their needs.²

FACTORS AFFECTING THE NEED FOR A SERVICE AUDITOR'S REPORT

4. A user auditor determines by various means whether the financial statements of the client organization are free of material misstatements resulting from the accounting or custodial services provided by the service organization. The nature, timing, and extent of the procedures that he decides to use depend on several factors, including the significance of the transactions processed or assets handled by the service organization and the accounting control procedures of the client organization relating to those transactions and assets.

5. The nature and extent of the client organization's accounting control procedures relating to its transactions processed or assets handled by the service organization can vary widely depending on (a) the type of agreement with the service organization, (b) the extent of information maintained by the client organization, and (c) the extent and timing of information furnished to the client organization by the service organization. For example, a client organization may use a service organization to process data but may maintain accounting data independent of the service organization and have control procedures designed to assure that transactions have been authorized, initiated, approved, executed, and recorded and that accountability is maintained for the related assets. At the other extreme, a client organization may receive only monthly statements and have no independent accounting data for transactions initiated and recorded by the service organization and virtually no control procedures over the execution and recording of transactions and the maintenance of accountability for related assets.

6. The user auditor should obtain an understanding of the flow of transactions through the portion of his client organization's accounting system that is maintained by the service organization as a basis for determining whether the controls on which he plans to place reliance are those of the client organization, the service organization, or some combination of both. The user auditor should identify significant classes of transactions that are processed or significant assets and liabilities that are handled by a service organization and consider the division of control functions between the client organization and the service organization.

7. Controls solely in the client organization may be sufficient to

¹ This Statement amends SAS No. 30, paragraphs 2 and 60, by adding the following footnote: "For guidance on reporting to another independent accountant on internal accounting control, see SAS No. XX, *Special-Purpose Reports for Use by Other Auditors*."

² The auditor's study and evaluation of internal accounting control in an examination of financial statements is discussed in SAS No. 1, section 320, and in SAS No. 3. The guidance in such statements is generally applicable also to the service auditor's study and evaluation in the engagements described above. This Statement is intended to provide, in general terms, additional guidance that should be applied in conjunction with guidance in various AICPA industry audit guides and statements of position (see Appendix).

achieve all the appropriate control objectives relating to particular accounting applications processed by a service organization. In such circumstances, the control procedures of the service organization are redundant, and a report from the service auditor ordinarily will not be necessary for the user auditor to evaluate the reliance that can be placed on the system of internal accounting control.

8. If a combination of controls is required to achieve the client's control objectives, certain service organization controls, such as those over editing of input, can be effectively tested by the user auditor at the client organization. In those cases a service auditor's report on the design of internal accounting controls maintained by the service organization (paragraphs 15 through 20) would normally be sufficient for the user auditor to design appropriate tests of compliance with such controls. Other control procedures, such as those involving program design and changes, can be tested only at the service organization. If the user auditor intends to rely on such controls, he should obtain a service auditor's report that covers design and compliance (paragraphs 15 through 24).

9. If the service organization has responsibility for custody of assets, depending on the extent of control at the client organization, it may be necessary for the user auditor to obtain a service auditor's report expressing an opinion on the system of internal accounting control of the segment of the service organization that has responsibility for custody of assets (paragraphs 25 through 33).

10. In addition to a report on internal accounting control, a report on substantive tests applied by a service auditor to the client organization's transactions or assets may be appropriate (paragraphs 34 and 41).

11. If a user auditor concludes that a report from a service auditor could be useful, the user auditor should contact the service organization through the client organization to determine the type of report that is to be issued. If no report is to be is-

sued or the report to be issued is inappropriate for his purposes and the client organization cannot influence that decision, the user auditor may have to apply procedures at the service organization or qualify or disclaim an opinion because of a limitation on the scope of his examination.

RESPONSIBILITIES OF THE SERVICE AUDITOR AND THE USER AUDITOR

12. The service auditor is responsible for the representations in his report to user auditors and for due care in the application of procedures that support those representations. Although the nature of his service differs from an examination of financial statements in accordance with generally accepted auditing standards, the services should be performed in accordance with the general standards and those other standards that are relevant. The service auditor may add a paragraph to his report stating that he is independent with respect to the service organization under the requirements of the American Institute of Certified Public Accountants and, if appropriate, the requirements of the Securities and Exchange Commission. It is neither necessary nor practical to require the service auditor to be independent with regard to each client organization.

13. The user auditor remains responsible for evaluating the system of internal accounting control as it affects the audit of the client organization's financial statements and for determining whether the service auditor's report is satisfactory for his purposes. If the user auditor is satisfied with the service auditor's independence with respect to the service organization and his professional reputation, he may use the service auditor's report in conducting his audit. Appropriate sources of information concerning the professional reputation of the service auditor are listed in SAS No. 1, section 543.10a. In considering whether the service auditor's report is satisfactory for his purposes, the user auditor may make inquiries of the service auditor or request to review the service auditor's working papers.

TYPES OF REPORTS AND TIME PERIOD COVERED

14. The user auditor should consider whether the type of report and the time period covered by it are satisfactory for his purposes.

- a. *Reports on the design of a system* would normally relate to the system as of a specified date (but may include comments on significant changes within a period). These reports should include a detailed description of the segment of the system of internal accounting control of the service organization that is relevant to the client organization in sufficient detail to allow the user auditor to design tests of compliance.
- b. *Reports on the design of a system and compliance tests that are limited to specific objectives of internal accounting control*, ideally, should relate to the entire period of reliance. These reports should also include a detailed description of the segment of the system of internal accounting control of the service organization that is relevant to the client organization.
- c. *Reports on a system of the segment of the service organization that has responsibility for custody of assets* should also, ideally, relate to the entire period of reliance. This type of report does not include a detailed description of the service organization's system of internal accounting control as found in reports on design and reports that are limited to specific objectives of internal accounting control, but states that the system of the segment of the service organization that has responsibility for custody of assets was sufficient to achieve certain broad objectives over a period of time (see paragraphs 29 through 33).
- d. *Reports on substantive tests* may be as of an interim date or as of the year-end date. These reports should include a description of the substantive tests applied by the service auditor and the results of those tests. If substantive tests are applied at an interim date, the user auditor should follow the guidance in SAS No. 1, section

310.66 in making his year-end audit tests.

15. SAS No. 1, section 320.61 lists the following factors to be considered by an auditor in deciding whether tests of compliance need to be applied to the period from the date of interim work to a client's year end: "(a) the results of the tests during the interim period, (b) responses to inquiries concerning the remaining period, (c) the length of the remaining period, (d) the nature and amount of the transactions or balances involved, (e) evidence of compliance within the remaining period that may be obtained from substantive tests performed by the independent auditor or from tests performed by internal auditors, and (f) other matters the auditor considers relevant in the circumstances." The user auditor's inquiries concerning the period since the date of the service auditor's last report should include inquiring of the service auditor or the service organization concerning any significant subsequent changes in internal accounting controls and, if the user auditor determines it is necessary, requesting additional procedures.

16. Because of the possibility of the distribution of client organization year ends throughout the calendar year, in some situations the service organization might, for example, engage the service auditor to issue a report as of the end of each calendar quarter covering the twelve-month period then ended.

ORGANIZATIONS THAT PROCESS TRANSACTIONS BUT DO NOT HAVE RESPONSIBILITY FOR CUSTODY OF ASSETS

17. The user auditor should consider controls in effect at the service organization and control weaknesses, if any, to be part of the client organization's system of internal accounting control. The user auditor should obtain an understanding of the flow of transactions through the portion of his client organization's accounting system maintained by the service organization and the extent to which those control procedures designed to

be in use at the service organization on which he plans to rely would achieve certain specific control objectives identified by the service auditor, assuming satisfactory compliance. This can be accomplished by obtaining a service auditor's report that describes in reasonable detail for significant accounting applications the specific control objectives that relate to points in the flow of transactions where errors and irregularities could occur and the specific control procedures that are designed to achieve those objectives.

18. The information required for the service auditor's report on design of the system ordinarily is obtained through discussion with appropriate service organization personnel and reference to various forms of documentation such as systems flowcharts and narratives. The scope of testing for this type of report is not as extensive as the scope of testing for a report on both design and compliance, but the service auditor should be satisfied that actual operations and control procedures are consistent with the description of the system as of a specified date. This may be accomplished by tracing a limited number of transactions through the related documents and records maintained and by making observations and corroborative inquiries at or near the date specified in the report, commonly referred to as a "walk-through." The service auditor is not required to specifically search or test for changes in the system that may have occurred before the beginning of fieldwork. In the course of the review, however, the service auditor may become aware that such changes occurred. If the service auditor believes the changes may be significant to achieving control objectives he has identified, the changes should be described in the report. Changes that occurred more than twelve months before the date being reported on would not normally be considered significant, because they generally would not affect the user auditor's procedures.

19. If weaknesses or deficiencies in design are noted, the service auditor's report should describe such con-

ditions. These conditions might include control procedures that have been described by the service organization as existing, but that are not present, as well as control procedures that are not included in the design but that, in the judgment of the service auditor, are necessary to achieve a control objective. Conditions identified by the service auditor may not be weaknesses in the client organization's overall system of internal accounting control, because even if errors or irregularities may occur and not be detected by the service organization, the client organization may have procedures that would detect them.

20. Regardless of how the control procedures have been designed to achieve the related control objectives, the user auditor cannot place reliance on a control procedure that is not being applied as prescribed. Accordingly, based on the service auditor's report, the user auditor should identify control procedures that can be tested at the client organization and those that can be tested only at the service organization. For procedures that can only be tested at the service organization, the user auditor should determine whether the service auditor's report covers compliance tests of those controls over a satisfactory period. If not, the user auditor may arrange to have the service auditor report on the results of applying agreed-upon procedures for testing compliance with those control procedures on which he intends to rely.

21. Evaluation of compliance with internal accounting control procedures may be based on a combination of inquiry, observation, tests of the details of transactions, or other means of investigation. To assist the user auditor in determining whether the service auditor's report is satisfactory for his purposes, the report should state a conclusion as to whether the control procedures and the degree of compliance with them were sufficient to achieve, in all significant respects, the specific control objectives they were designed to achieve.

22. The information provided in a report covering design and compliance, when combined with his knowledge of control procedures in place at the client organization, should provide the user auditor with the ability to evaluate questions such as these:

- Do controls provide reasonable assurance that application programs and systems are designed, implemented, and maintained in accordance with management's general or specific authorizations?
- Do controls over input provide reasonable assurance that data received for processing has been authorized and that data has not been lost, suppressed, added, duplicated, or otherwise improperly changed?
- Do controls over processing provide reasonable assurance that processing has been performed as intended for the particular application; i.e., that all data are processed as authorized, that no authorized data are omitted, and that no unauthorized data are added?
- Do controls over output provide reasonable assurance that the processing results are accurate and that only authorized personnel receive the output?

23. After considering the service auditor's report, the user auditor may conclude that internal accounting control procedures within the overall system appear to provide a basis for reliance thereon and for restricting the extent of substantive tests.

24. If the report of the service auditor discloses weaknesses either in the design of the service organization's system of internal accounting control or the extent of compliance with prescribed procedures, the user auditor will need to assess the effect of such weaknesses and consider the need for more extensive substantive tests.

ORGANIZATIONS THAT INITIATE OR PROCESS TRANSACTIONS AND HAVE RESPONSIBILITY FOR CUSTODY OF ASSETS

25. Service organizations that initiate or process transactions may also be designated as trustees under a formal agreement. An example of one such arrangement is a formal trust agreement executed by an administrator of a pension plan with a bank as trustee. Generally, a bank acting as trustee also has responsibility for custody of those assets under its control.

26. A trust agreement may provide for discretionary or nondiscretionary control over trust assets. A discretionary trust gives the trustee authority to purchase or sell trust assets within the framework of the trust agreement. A nondiscretionary trust allows the trustee to purchase or sell trust assets only at the direction of the party named as having discretion, such as a plan administrator, investment committee, or investment advisor. In a nondiscretionary trust, the plan would ordinarily maintain a record of the instructions given to the trustee concerning the specific transactions to be executed by the trustee.

27. Regardless of the type of trust agreement, the user auditor usually cannot physically inspect securities certificates held by the trustee. For example, many trustees do not maintain securities by individual trust accounts and do not hold securities in the plan's name; rather, they hold them in the trustee's or nominee's name. Also, trustees may participate in centralized vault services such as those offered by independent depositories and clearing associations. Under those circumstances, it may not be possible to specifically identify those securities belonging to the client organization being examined.

28. The trustee is legally responsible for the safekeeping of the assets and the execution of transactions in accordance with the general and specific authority granted by the client organization. Absent evidence to the contrary, the trustee is presumed to be financially capable of fulfilling

its trust obligations. The receipt of a confirmation of trust transactions and assets directly from the trustee, along with reading the trustee's financial statements to evaluate the institution's underlying financial stability, constitutes a part of the evidential matter needed to form an opinion on the client organization's financial statements. The auditor should apply additional audit tests to the information received by the client organization from the trustee.

29. In addition, for discretionary trusts, the user auditor should either obtain a report on the system of internal accounting control of the segment of the trustee that has responsibility for custody of assets or apply alternative audit procedures at the service organization that provide reasonable assurance that the information received from the service organization is reliable.

30. The service auditor's report should include an opinion on the system of internal accounting control, over a period of time, of the segment of the trustee that handles trust assets. The service auditor's engagement might include inspection and confirmation of securities or other assets and tests of transactions but without particular regard to an individual plan or account. This approach greatly reduces the duplication of effort in the study and evaluation of internal accounting control that would otherwise be necessary if each user auditor were to attempt to conduct his own examination of the trustee without having a general familiarity with the procedures, controls, records, and personnel of the trustee.

31. The form of opinion on a system of internal accounting control specified in SAS No. 30 is that the system taken as a whole was sufficient to meet the objectives of internal accounting control "insofar as those objectives pertain to the prevention or detection of errors or irregularities in amounts that would be material in relation to the [entity's] financial statements." However, in reporting on the internal accounting control of a segment of a trustee that handles trust assets, the basis for assessing the ma-

teriality of potential errors or irregularities is the financial statements of the trustee rather than the segment because the relationship of potential errors and irregularities to the segment's financial position is not meaningful.

32. The service auditor's report will not necessarily include a list of each compliance deviation, or error, found in the records during his tests. Generally, the service auditor's discovery of deviations relating to transactions processed for others will not preclude him from reaching a conclusion that a system's objectives were achieved if he believes the rate of occurrence of deviations is not significant in relation to the number of records examined or if occurrences have been detected and corrected in the normal functioning of the accounting system.

33. Even though the specific errors or irregularities detected or the conditions that permitted them may not be significant to his overall evaluation, the service auditor should consider the appropriateness of the actions taken by management to correct such matters. If the service auditor believes the errors (including differences between the records and the reports submitted by the service organization to the client organization) would be material to the affected client organization's assets in custody, or if he detects irregularities, he should request that the service organization report them to the client organization. If the service organization does not report the errors or irregularities to the client organization, the service auditor should describe them in his report.

TESTING OF SPECIFIC CLIENT ORGANIZATION TRANSACTIONS OR BALANCES

34. The user auditor should recognize that the audit procedures and tests of the accounting records made by the service auditor are generally applied to the collective transactions processed or assets held by the service organization and will not necessarily include tests of his client organization's specific transactions or

assets. If the report issued by the service auditor is not sufficient to meet the objectives of the user auditor, the user auditor may supplement his understanding of the service auditor's procedures and conclusions by reviewing the service auditor's working papers and discussing with the service auditor the scope and the results of his work. Also, if the procedures that the service auditor has applied are not similar to those that the user auditor would have applied, the user auditor may request the service auditor to make specific tests of the service organization's records that apply particularly to his client organization's transactions and assets.

REFERENCE TO A SERVICE AUDITOR'S REPORT

35. The service auditor's report is used by the user auditor primarily as part of the study and evaluation of the client organization's system of internal accounting control in determining the nature, timing, and extent of audit procedures, not as a substitute for his audit procedures. The user auditor exercises professional judgment in selecting the audit procedures to be applied in the circumstances. Also, the service auditor's report represents only part of the evidential matter obtained by the user auditor. Accordingly, in reporting on his examination of the financial statements, the user auditor should not make reference to the report of the service auditor as a basis, in part, for his own opinion because there cannot be a meaningful indication of a division of responsibility for the financial statements. The service auditor's report is used as evidential matter in expressing an opinion, but, regardless of the materiality of the amounts involved, the service auditor is not responsible for examining a portion of the financial statements as of any specified date or for any specified period of time. Also, there may be an inference that the auditor making such reference performed a more thorough audit than an auditor not making such reference.

36. If the user auditor uses the service auditor's report in an engagement to report on his client's system

of internal accounting control, the user auditor may decide to refer to the service auditor's report in accordance with the guidance given in SAS No. 30, paragraph 45. In this case, the portion of the responsibility of the service auditor can be specifically identified.

ILLUSTRATIVE REPORTS

37. The following reports are illustrative only and should be modified as appropriate to suit the circumstances of individual engagements.

Report on the Design of a System

38. The following type of report is considered appropriate when an auditor reports on the design of internal accounting controls maintained by a service organization, in this case, an EDP service center. The report assumes that the description of operations and control procedures is divided into two sections: Section 1 is the service organization's description of the system; section 2 lists specific control objectives and describes control procedures that achieve those objectives.

We are independent certified public accountants with respect to Blank Service Center within the meaning of the code of professional ethics of the American Institute of Certified Public Accountants.

We have reviewed the accompanying description of the operations and control procedures of the Blank Service Center and its savings account and mortgage loan processing systems as of (date). Our review included procedures we considered necessary in the circumstances to provide reasonable assurance that the accompanying description is consistent with actual procedures and to evaluate the design of the control procedures specified in section 2. We did not test compliance with the control procedures; accordingly, we do not express an opinion on whether those controls were being applied as prescribed for any period of time. A further description of our review and its objectives is attached.

Because of inherent limitations in any system of internal accounting control, errors or irregularities may occur and not be detected. Also, projection of any evaluation of the system to future pe-

riods is subject to the risk that procedures may become inadequate because of changes in conditions.

In our opinion, the control procedures included in the accompanying description are consistent with actual procedures of the Blank Service Center and its savings account and mortgage loan processing systems as of (date) in all significant respects, and the control procedures specified in section 2 are suitably designed to achieve, in all significant respects, the control objectives specified therein if complied with satisfactorily.

This report is intended solely for use by management of Blank Service Center and the independent auditors of its customers.

Report on the Design of a System and Compliance Tests That Are Limited to Specific Objectives of Internal Accounting Control

39. The following type of report is considered appropriate when an auditor reports on the design of, and compliance with, certain internal accounting controls maintained by a service organization, in this case, an EDP service center. The report assumes that the description of operations and control procedures is divided into two sections: Section 1 is the service organization's description of the system; section 2 lists specific control objectives and describes control procedures which achieve those objectives.

We are independent certified public accountants with respect to Blank Service Center within the meaning of the code of professional ethics of the American Institute of Certified Public Accountants.

We have reviewed the accompanying description of the operations and control procedures of the Blank Service Center and its savings account and mortgage loan processing systems from (date) to (date). Our review included such tests as we considered necessary to (a) provide reasonable assurance that the description in section 1 conformed to actual procedures and (b) evaluate whether the procedures described in section 2 are sufficient to achieve in all significant respects the control objectives specified therein. We tested compliance only with the control procedures listed in section 2. Accordingly, we do not express an opinion on whether all of the controls described in

section 1 were being applied as prescribed for any period of time. A further description of our review and its objectives is attached.

Because of inherent limitations in any system of internal accounting control, errors or irregularities may occur and not be detected. Also, projection of any evaluation of the system to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the degree of compliance with the procedures may deteriorate.

In our opinion, the accompanying description conformed to the actual procedures of the Blank Service Center and its savings account and mortgage loan processing systems from (date) to (date), and the control procedures described in section 2 were sufficient to achieve, in all significant respects, the control objectives specified therein.

This report is intended solely for use by management of Blank Service Center and the independent auditors of its customers.

Report on a System of the Segment of a Service Organization That Has Responsibility for Custody of Assets

40. The following type of report is considered appropriate when an auditor expresses an opinion on a system of internal accounting control of a segment of a service organization that has responsibility for custody of assets maintained by a service organization, in this case, a trust department of a bank.

We are independent certified public accountants with respect to Blank Bank and Trust Company within the meaning of the code of professional ethics of the American Institute of Certified Public Accountants.

We have made a study and evaluation of the system of internal accounting control of the trust department of Blank Bank and Trust Company that existed during the period from (date) to (date), which department has responsibility for personal, custodial, and corporate trust accounts. Our study and evaluation was conducted in accordance with standards established by the American Institute of Certified Public Accountants. It included inspection and confirmation, on a test basis, of assets held for such accounts, tests of transactions in and the administration

of selected accounts, and observation and review of the procedures followed by the internal audit department. The management of Blank Bank and Trust Company is responsible for establishing and maintaining a system of internal accounting control. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of control procedures. The objectives of such a system are to provide management with reasonable, but not absolute, assurance that assets for which the trust department has responsibility are safeguarded against loss from unauthorized use or disposition and that transactions are executed in accordance with management's authorization and in conformity with the governing instruments and are recorded properly to permit the preparation of the required financial reports.

Because of inherent limitations in any system of internal accounting control, errors or irregularities may occur and not be detected. Also, projection of any evaluation of the system to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the degree of compliance with the procedures may deteriorate.

In our opinion, the system of internal accounting control of the trust department of Blank Bank and Trust Company that existed during the period from (date) to (date), taken as a whole, was sufficient to meet the objectives stated above insofar as those objectives pertain to the prevention or detection of errors or irregularities in amounts that would be material in relation to the financial statements of Blank Bank and Trust Company.³

REPORTS ON SUBSTANTIVE TESTS

41. In addition to reports on internal accounting control, a service auditor might be engaged to report on the results of making substantive tests of accounting records relating collectively to the transactions or assets of many client organizations, such as organizations that service loans. The transactions processed and assets held for others are generally not included in the financial

³ This report is prepared in conformity with the requirements of SAS No. 30, paragraph 2a; therefore, restriction of its use is not necessary.

statements of the service organization. Accordingly, although audited financial statements of the service organization might be useful to the user auditor in considering the capability of the service organization to fulfill its responsibilities, such financial statements alone would not constitute evidential matter concerning the occurrence or existence of the client organization's transactions or assets. However, if the service auditor made tests such as counting securities or confirming account balances, the service auditor's report on those substantive tests would serve to provide the user auditor with a reasonable basis for concluding whether, for example, the assets exist and are owned by the client organization.

42. The following type of report is considered appropriate when an

auditor's examination included substantive tests of assets serviced for others, in this case, confirmation of mortgage balances.

We are independent certified public accountants with respect to Blank Mortgage Company within the meaning of the code of professional ethics of the American Institute of Certified Public Accountants.

We have examined the financial statements of Blank Mortgage Company for the year ended (date) and have issued our report thereon dated (date). Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances. The examination referred to above included tests relating to mortgage loans serviced for others in accordance with the requirements of

the Uniform Single Audit Program for Mortgage Bankers. The selection of mortgagors to whom requests for confirmation of principal and escrow balances were sent was made on the basis of a statistical sampling plan applied as we considered appropriate based on our evaluation of the company's internal accounting control. On this basis, such confirmations were requested of all balances in excess of \$_____ and of approximately _____% of the total number and _____% of the total principal balances of all other mortgages being serviced for others at the date for which the confirmations were requested. Our examination disclosed no exceptions or errors relating to mortgage loans serviced for others.

APPENDIX

EXAMPLES OF SERVICE ORGANIZATIONS

The following listing of service organizations is not intended to be all-inclusive nor is it intended to suggest that the approach described in this Statement needs to be applied in each situation

1. Organizations that process transactions but that do not have a fiduciary responsibility for custody of assets

- *Service centers that provide data processing functions for other organizations.* Service centers offer a range of services, including providing time-shared computer services, processing standard program packages, and designing and processing tailored systems. The service center may specialize in a particular application, such as payroll or inventory, or in a particular industry, such as securities brokerage or savings and loan. A service center that processes for different customers similar applications using the same computer programs, which have a significant effect on the financial data of each of its users, could be the subject of a study and evaluation of internal accounting control by a service auditor. For additional information on service centers, see the AICPA Audit Guide, *Audits of Service-Center-Produced Records*.
- *Insurers that maintain the accounting for ceded policies.* Reinsurance is the assumption by one insurer of all or part of a risk originally undertaken by another insurer. The extent of the information provided to the assuming company by the ceding company can vary significantly. The independent auditor of the assuming company, as an alternate procedure, may obtain a report on internal accounting control related to ceded reinsurance from the ceding company's independent auditor. An AICPA task force is developing statements of position on auditing reinsurance transactions.

2. Organizations that have a fiduciary responsibility for custody of assets but that do not initiate transactions

- *Securities depositories or clearing organizations.* One broker or dealer in securities may perform services such as the execution and clearance of trades for another broker or dealer. The service organization may hold a significant amount of securities of the broker or dealer and may engage an independent auditor to report on its internal accounting controls. For additional information on securities held at depositories, see the AICPA Industry Audit Guide, *Audits of Brokers and Dealers in Securities*, 2d. ed.

3. Organizations that initiate transactions and have a fiduciary responsibility for custody of assets

- *Trust departments of banks or similar entities.* A formal trust agreement may be executed by the administrator of a pension plan or a trust and a bank or insurance company as trustee. Generally, a bank acting as trustee is also custodian of those investments under its control. In addition, the trust agreements may provide for discretionary or nondiscretionary control over trust assets. A discretionary trust gives the trustee authority to purchase or sell trust assets within the framework of the trust agreement. A nondiscretionary trust allows the trustee to purchase or sell trust assets only at the direction of the party named as having discretion, such as an administrator, investment committee, or investment advisor. A bank trust department may engage an independent auditor to perform a study and evaluation of the trust department's internal accounting controls and issue a report setting forth the scope of the review and the accountant's opinion on the system.

This report would then be available to the auditors of the employee benefit plans and the trusts. For additional information concerning the audits of pension plans, see the exposure draft of the proposed AICPA Audit Guide, *Audits of Employee Benefit Plans*.

- *Mortgage bankers or savings and loan associations that service loans for others.* Some organizations purchase mortgage loans, or participation interests in such loans, from savings and loan associations, banks, or mortgage companies. The seller continues to service the loans, but the loans are not assets of the service organization. The service organization's independent auditors may issue a report confirming the extent to which their examination included confirmation and other procedures for such loans and the results. For additional information on mortgage loans, see the AICPA Industry Audit Guides, *Savings and Loan Associations*, Rev. ed.; *Audits of Fire and Casualty Insurance Companies*, 3d. ed.; and *Audits of Stock Life Insurance Companies*, 2d. ed.

4. Organizations that handle liabilities or equities

- *Banks or trust companies acting as registrar or transfer agent for a corporation.* Corporations often appoint banks or trust companies to act as registrars or transfer agents. Registrars account for the original and subsequent issues of a corporation's capital stock, the cancellation of certificates presented for transfer, and their reissue. Registrars also maintain the corporation's stock register. Transfer agents make legal transfers of a corporation's outstanding capital stock and keep the shareholders ledger from which shareholder lists are prepared for use in paying dividends, issuing stock warrants, and for other corpo-

rate purposes. The functions of registrar and transfer agent are often combined. The independent audi-

tor of a corporation may request a report on internal accounting control relating to a bank or trust com-

pany's performance of these functions.